

WORKING PAPER SERIES - 275

PROFIT SHARING AND GAIN SHARING  
FOR IMPROVED JOB SECURITY AND MACROECONOMIC PERFORMANCE

by

*Daniel J.B. Mitchell*

*Daniel J.B. Mitchell*

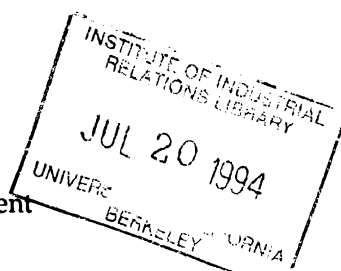
Professor, Anderson Graduate School of Management

University of California, Los Angeles

Los Angeles, CA 90024-1481

Telephone: (310) 825-1504

Fax: (310) 829-1042



DRAFT: June 1994

INSTITUTE OF INDUSTRIAL RELATIONS  
UNIVERSITY OF CALIFORNIA  
LOS ANGELES

**Profit Sharing and Gain Sharing  
for Improved Job Security and Macroeconomic Performance**

Daniel J.B. Mitchell  
Professor  
Anderson Graduate School of Management  
U.C.L.A.  
Los Angeles, California 90024-1481  
Phone: 310-825-1504  
Fax: 310-829-1042

July 15, 1994

Written testimony for a hearing of the House Committee on Small Business, Subcommittee on Regulation, Business Opportunities, and Technology, Representative Ron Wyden, Chairman.\*

---

\* An earlier version of these remarks was delivered at the 68th Annual Western Economic Association Conference, panel on "Policy Implications of Research on Employee Ownership and Profit Sharing," June 21, 1993, Lake Tahoe, California. Panel organizer: Michael A. Conte.

## Highlights

- Profit Sharing and Gain Sharing should be encouraged because of their potential macroeconomic benefits in stabilizing and possibly expanding employment. However, the alleged favorable impacts of such plans on productivity to do not provide a rationale for subsidization, since market incentives are already present for micro productivity effects.
- Favorable tax treatment should be provided only to plans which provide explicit formulas linking pay to profit, revenue, or some other value measure, and which put a significant fraction of pay at risk, say 10-30%.
- Favorable tax treatment should not be conditioned on paying bonuses into a deferred retirement fund.
- Employee Stock Ownership Plans (ESOPs) do not in general provide the kind of macro benefits worthy of public subsidy. Tax expenditures now attributable to ESOPs and to discretionary (non-formula) profit sharing should be redirected toward genuine profit and gain sharing plans.
- There is a limited case for government provision of information concerning alternative pay plans, provided it is done in a neutral and accurate fashion. However, there is a substantial amount of private information already available. The issue is quality rather than quantity of information.
- Basic consistent government data on the incidence of profit sharing, gain sharing, and ESOPs are currently limited and could be much improved. More detailed information on the total tax expenditures currently in effect for deferred profit sharing and ESOPs is also needed. At present, much of tax loss is blended into a general category covering all retirement plans.
- The Dunlop Commission neglected pay systems in its recent interim report on worker-management relations. The report includes only limited discussion of ESOPs. Profit sharing and gain sharing encouragement should be major topics in the Commission's final recommendations. More generally, public officials should encourage widespread and significant use of true profit and gain sharing because of the potential macroeconomic and job security benefits.

## **Outline**

### **I. Plan Usage**

### **II. The Market Failure Rationale for Intervention**

### **III. The Merit Good Rationale for Intervention**

### **IV. The Social Transformation Rationale for Intervention**

### **V. Applying the Three Justifications to Profit Sharing, Gain Sharing, and ESOPs**

- i. Incentive Problems and Evidence**
- ii. Productivity is Not Grounds for Intervention**
- iii. Information Spreading Policies**
- iv. The Merit Good Rationale**
- v. The Social Transformation Rationale**

### **VI. An Alternative Macro Rationale**

- i. The Macro Case for Profit and Gain Sharing**
- ii. Lack of a Macro Case for ESOPs**
- iii. Empirical Evidence**

### **VII. How Much Are We Subsidizing ESOPs?**

### **VIII. Conclusions**

### **Tables**

### **Footnotes**

Should public policy encourage certain types of pay systems? In particular, should it encourage profit sharing and certain types of gain sharing plans? Are Employee Stock Ownership Plans (ESOPs) and other forms of "pay for performance" as equally deserving of public policy encouragement as are profit sharing and gain sharing.<sup>1</sup> These are the questions I will address.

Although the issue of whether such pay systems are "effective" or "ineffective" in raising productivity or cutting employer costs is important from the usual micro-level managerial viewpoint, I will argue that it is not especially important from a public policy perspective. The kinds of potential public policy encouragement I will consider are 1) subsidies (usually via the tax code), 2) information spreading, and 3) exhortation by public officials and official bodies. And, for these types of policies, it is probably best at this point to state my biases up front. Pay systems which do not have macroeconomic benefits, but simply are said to raise productivity or lower costs, have no special claim on the public purse for subsidies and only a marginal claim for information spreading or other encouragement.

This position is particularly important with regard to ESOPs. Whenever ESOPs are discussed, the worker ownership aspect has had an alluring effect on certain policy makers and social reformers. On the policy making side, former Senator (and chair of the Senate Finance Committee) Russell Long of Louisiana for many years viewed ESOPs as part of a new socio-economic order.<sup>2</sup> Social reformers - in particular the late Louis Kelso - had similar visions.<sup>3</sup>

The result of this approach has been a history of (unjustified in my view) special tax subsidies to ESOPs unavailable to other pay systems and which could have better been directed to appropriate forms of profit sharing and gain sharing. Financiers, managers, and professional compensation consultants took the tax subsidies that resulted from this attempt at social uplift through ESOPs and drew ESOPs into takeover battles, the retention of control of closely-held family enterprises, the obtaining of cheap loans, and tax avoidance. But in a time of federal budget deficits and pressures for fiscal economy, Congressional beneficence towards ESOPs has been eroding, as well it should.

In the past, especially in the 19th century, some reformers - and business owners - saw profit sharing as a way of educating workers on the benefits of capitalism and as a way of solving the "labor problem" of labor-management conflict. Gain sharing has also been seen from time to time as a route to smooth labor relations. But generally, today, it is possible to discuss profit sharing and gain sharing calmly from the personnel management perspective as ordinary employee incentive plans or - from the economist's perspective and more relevant to the matter of public subsidy - as employer incentive plans.

Although I argue that profit sharing and gain sharing are more deserving of subsidy than ESOPs or other pay systems, I do not have in mind all plans that today are commonly grouped under the profit sharing or gain sharing labels. Many profit sharing plans in fact do not vary pay systematically with profits or vary too small a portion of pay to matter. To qualify for a tax subsidy, profit sharing plans need to contain a written formula linked to profits and need to put a substantial fraction of pay, say 10-30% or more, "at risk." This percentage is notably higher than typical American practice.<sup>4</sup> On the other hand, the payment of profit sharing bonuses into a deferred retirement-type fund should not be a criterion for tax subsidy. Gain sharing plans also should systematically relate pay to a value-oriented measure (such as plant-level profits, revenue, or value added) to receive a subsidy. And again, a significant fraction of pay should be at risk. On the other hand, gain sharing plans that are essentially group piece rates are not appropriate candidates for subsidy (nor are ordinary, individual piece rates).

When public policy matters are discussed, the issue - at least as posed by economists - is often one of alternatives. Are there better uses for the money than the specific purpose being proposed? In the abstract, posing the issue that way is attractive. In practice, however, such discussions can







































